

# AGENDA PAPER

IFRS Foundation Trustees' meeting—Due Process Oversight Committee

London

10 April 2013

Agenda paper 3B

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**To:** Scott Evans, Chairman—Due Process Oversight Committee

**From:** Sue Lloyd

**Date:** 25 March 2013

**Re:** Hedge accounting: due process 'life cycle' review

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## Overview

This report covers the due process steps and considerations for the IASB's hedge accounting project.

- Appendix A summarises discussions with the Trustees and the DPOC that have occurred in relation to this project.
- Agenda paper 3B (i) is the *draft* Due Process paper for the April 2013 IASB meeting<sup>1</sup>; and
- Agenda paper 3B (ii) is the *draft* paper for the April 2013 IASB meeting confirming that re-exposure is not required and requesting permission to ballot.

In addition to the detailed life cycle analysis of the project that is contained in Agenda paper 3B (i) I would like to highlight some key considerations.

## Due process efforts undertaken

The hedge accounting project began with the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* published in March 2008. This was followed by an Exposure Draft that was published in December 2010. During the comment period the staff and Board members of the IASB undertook what was (and continues to be) one of the most extensive outreach programmes the IASB has undertaken in relation to a project. Throughout the consultation period more than 2,500 individuals participated in the IASB's outreach

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<sup>1</sup> The draft paper assumes that the staff will recommend clarifications to IFRS 9 that will enable the IASB to proceed to finalise the hedge accounting phase of that project. *That analysis was not final as at the date of posting this agenda paper.*

activities. This was accomplished through a total of 145 meetings were held across major geographical regions including Africa, Asia Pacific, Europe, North America, Central America and South America. Participants included auditors, regulators, users, national standard setters, treasurers, risk management experts and academics.

The Exposure Draft was well received. In particular, there was broad support with the overall objective of improving the alignment with risk management practices and in improving the quality of information provided to the users of financial statements about entities' risk management practices. The main consideration in redeliberations was clarification of new concepts.

Post redeliberations the IASB decided to take an additional non-mandatory step of publishing a draft of the final requirements on our website for a 90 day period. This was not to obtain comments on the decisions made by the IASB in its redeliberations. Rather it was to enable interested parties to familiarise themselves with the draft document and to raise any questions regarding clarity and/or the accuracy of the reflection of the IASB's decisions.

We did not formally solicit comments but did receive comments on the document. At the January 2013 meeting the IASB discussed three key issues raised in response to the draft documents and agreed to make changes to the draft that addressed the concerns raised in relation to two of those issues<sup>2</sup>.

The IASB also made decisions that would assist on the third issue (clarifying how the model would be applied for so-called macro hedging activity). However, a broader related issue, the question of whether we would require entities to apply IFRS 9 to all macro hedging activity (essentially the risk management of open portfolios of items) was not fully resolved. The IASB asked that the staff do additional outreach on this issue. This (final) issue will be discussed at the April 2013 Board meeting.

### **Accounting for macro hedges**

In the deliberations that preceded the 2010 Exposure Draft the IASB decided to deal with macro hedge accounting (accounting for hedges of open portfolios of items) separately. *The Exposure Draft thus did not address macro hedge accounting.* This was intentional. In the redeliberations the IASB went a step further and, in view of the complexity of macro hedge accounting and the desire to complete IFRS 9 *Financial Instruments* on a timely basis decided to formally separate macro hedge accounting from the IFRS 9 project (rather than doing it separately but as a second step within the IFRS 9 project).

The reason for this decision was two-fold. Firstly, the proposals in the Exposure Draft would result in a material improvement in hedge accounting for those hedging *non-financial exposures*. In contrast, the focus of macro hedge accounting, while not limited to financial exposures, is of most interest to financial institutions in their hedges of financial exposures.

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<sup>2</sup> Namely (i) using 'hypothetical derivatives' to measure the change in the value of the hedged item and (ii) the transition requirements for the designation of 'own use' contracts at fair value through profit or loss.

The IASB was keen that corporates could therefore benefit from these improvements expeditiously. Secondly, the area of accounting for macro hedging is notoriously complex. It is also highly politicised—it is for example the subject of the European carve out from IFRS. To ‘get it right’ the staff recommended and the IASB agreed that it would be appropriate to first publish a Discussion Paper to ensure that the alternatives, information content and operational considerations were well understood and that interested parties would have sufficient time to be involved in the development of the proposals. In so doing the IASB also decided to grandfather *macro hedge accounting*, ie to allow macro hedge accounting in IAS 39 to continue to be applied until the broader project is completed.

The decision to separate out macro hedge accounting has been widely supported.

The question that has arisen however is what happens (particularly to banks) in the period between finalising (general) hedge accounting and the macro project.

The debate has been hampered by confusion in terminology. So at this point it is perhaps helpful to try to represent diagrammatically the issue currently being debated. In this diagram I differentiate between *macro hedging* (ie the risk management activity) and *accounting for macro hedging* (ie how the activity is accounted for). The diagram illustrates how IAS 39 is currently applied and what the Review Draft proposed.

### Accounting applied to macro hedging activity

#### What happens today – and what would happen per the Review Draft

All macro hedging activity		
IAS 39 – accounting applied		
No hedge accounting	(‘Red’ column)  Macro hedge accounting  Portfolio fair value hedge accounting for interest rate risk	(‘Blue’ column)  Other hedge accounting (application of <u>micro</u> hedge accounting)

The Review Draft would result in entities being required to migrate their accounting for macro hedging activities to IFRS 9—except for those applying the specific macro hedge accounting model that is already contained in IAS 39 (marked in red above). As the diagram shows that is not the same as allowing everyone applying hedge accounting to these activities to continue to apply their IAS 39 hedge accounting.

Some have requested that not only macro hedge accounting should continue to be accounted for under IAS 39 but also hedge accounting for other macro hedging activities (so they would

want the population in blue AND the population in red to stay within IAS 39). The staff believes that the only technically robust way to do that (given that the only definition of ‘macro hedge accounting’ that we have in our literature currently is that highlighted in red) would be to allow *a free choice* of whether entities apply IFRS 9 hedge accounting or IAS 39 hedge accounting.

At the heart of the debate is how burdensome it would be to require the population in blue to migrate to IFRS 9 (and then potentially migrate to the new macro model when it is complete). That issue will be fully discussed by the IASB at the April Board meeting.

## Appendix A

**HEDGE ACCOUNTING DUE PROCESS LIFE CYCLE REVIEW: REPORTING TO THE TRUSTEES AND THE DUE PROCESS OVERSIGHT COMMITTEE (DPOC)**

Date	Trustees/DPOC	Report
Mar 2008	Trustees	Reference in the <i>Report of the IASB Chairman</i> (Agenda Paper, AP4) anticipating the issue of a Discussion Paper (DP) on financial instruments that addressed measurement-related problems and hedge accounting.
Jul 2008	Trustees	Reference in the <i>IASB Chairman's Report to the Trustees</i> (AP4A) referring to the DP out for comment <i>Reducing Complexity in Reporting Financial Instruments</i> . Included a reference to possible intermediate approach to simplifying hedge accounting.
Oct 2008	Trustees	Reference in <i>The IASB's Work Plan – October 2008</i> (AP5B) to the comment period on the above DP having closed on 19 September 2008 and that the Board would consider moving the project from the research agenda to the active agenda in Q4 2008.
Jul 2009	Trustees	Reference in <i>The IASB's response to issues arising from the financial crisis</i> (AP4A) to the IASB's plans to publish an exposure draft (ED) to improve and simplify hedge accounting by end 2009.
Oct 2009	Trustees	Reference in <i>The IASB's response to issues arising from the financial crisis</i> (AP4A) to the IASB's plans to publish an ED to improve and simplify hedge accounting by end 2009.
Jan 2010	Trustees	Reference in <i>Report of the IASB Chairman</i> (AP4A) on IASB's expectation to publish an ED to improve and simplify hedge accounting in the 1 <sup>st</sup> half of 2010. Noted that the IASB was working with the US FASB to ensure convergence of hedge accounting approaches.
Mar 2010	Trustees	Reference in paper <i>The Technical Agenda</i> (AP2C(i)) to expectation of publishing in the 1 <sup>st</sup> half of 2010 an ED to improve and simplify hedge accounting.
Jul 2010	Trustees	Reference in <i>Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards</i> (AP5) to different approaches being taken by IASB (phased approach) and FASB (developing a comprehensive approach). Noted that in May FASB issued a comprehensive proposal including hedge accounting requirements. IASB planned to issue an ED of proposed hedge accounting requirements in Q3 2010.
Sep 2010	DPOC	Reference in <i>Project to replace IAS 39</i> . Noted that, In response to the overwhelming feedback received from the outreach activities that have been conducted, the Board was undertaking a comprehensive review of the hedge accounting requirements. The ED would address hedge accounting both for financial and for non-financial exposures, so, out of all the phases of the financial instruments project, this phase was of the greatest relevance to (non-financial) corporate stakeholders. ED expected to be published Q4 2010.
Oct 2010	Trustees	Reference in the <i>Report of the IASB Chairman</i> (Agenda Paper, AP7A) as in AP for DPOC September 2010.
Feb 2011	Trustees	Reference in <i>Chairman's Quarterly Review</i> (AP8A) to publication of hedge accounting ED in December 2010, with comment deadline 9 March 2011. Noted that: "The hedge accounting proposals do not include portfolio hedging. Some critics think that the hedge accounting model cannot be completed without also resolving portfolio hedging at the same time. The Board does not agree. However, to address these concerns, the Board plans to have its proposals related to portfolio hedging developed before it

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		finalises the more general hedging requirements. We therefore anticipate publishing an exposure draft for portfolio hedging this summer".
Mar 2011	DPOC	Reference in <i>DPOC: Update on Enhance Engagement</i> (AP6C(ii)) to the ED, noting that during the comment period, staff and Board members undertook outreach activities in six continents, meeting over 2,500 people in small group meetings and discussion forums. The Board received 233 comment letters, a summary of which was presented to the Board on 16 March. The paper also noted strong support for the proposals, with respondents welcoming the Board's approach to address hedge accounting comprehensively. They also agreed with the principle-based approach proposed in the ED, with many commenting that they thought the proposal would resolve many of today's practice problems in applying IAS 39.
Mar 2011	Trustees	Reference in <i>IASB Chairman's Report</i> (AP7) as in DPOC AP above. AP also noted that the ED did not address portfolio hedges. Noted that the IASB expected to develop its proposals on portfolio hedges before it finalised its general hedge accounting requirements and expected to issue an ED on portfolio hedging later in 2011.
Jun 2011	DPOC	Reference in <i>DPOC: General Update</i> (AP2) that IASB was continuing to consider ED comments and was aiming to finalise by Q3 2011. IASB had yet to consider whether re-exposure was necessary and was assessing whether to undertake further outreach related to drafting the final requirements. Still expecting to issue an ED on portfolio hedging later in 2011. The <i>Summary of the Conclusions of the meeting</i> noted that the DPOC reviewed the IASB's compliance with its due process for the hedge accounting project.
Jul 2011	DPOC	Reference in <i>DPOC: General Update</i> (AP2F). As above, plus a comment that the IASB had yet to determine the extent of drafting outreach.
Jul 2011	Trustees	Reference in <i>Report by David Tweedie, Immediate IASB Past Chairman</i> (AP8) with comments as per the reports submitted in March, June and July 2011.
Oct 2011	Trustees	References in <i>Report of the IASB Chair</i> (AP2 and Appendix B to AP2). On general hedge accounting model, noted that in September 2011 the IASB completed its deliberations and asked staff to prepare draft of final requirements, to be made available on the IASB website for about 90 days. Would provide opportunities to undertake extended fatal flaw process, additional outreach, and for FASB to consider the planned requirements. IASB had yet to complete its formal review of due process steps and whether re-exposure was necessary. Noted that IASB expected to publish an ED on portfolio (macro) hedging in H1 2012.
Oct 2011	DPOC	Reference in <i>DPOC: Due Process Handbook</i> (AP3F). As above for Trustees, plus comments under due process considerations that IASB would not complete its formal review of due process steps until the staff had completed the drafting review and reported back to the Board on whether any matters raised in it needed to be considered as sweep issues.
Jan 2012	Trustees	Reference in <i>Report of the IASB Chair</i> (AP2 and Appendix B) to decision to place staff draft on the website as part of an extended, 90 day, fatal flaw review (expected to be published January 2012) and to give FASB more time to decide how it wanted to proceed with its hedge accounting project. Noted (again) that IASB would not complete its formal review of due process steps until the staff had completed the drafting review and reported back to the Board. Also noted expectation that ED on portfolio (macro) hedging would be published in 2012.
Apr 2012	Trustees	References in <i>Report of the IASB Chair</i> (AP2) and <i>The Technical Agenda</i> (AP2B). Comments as for January 2012 but now noting that review draft document was expected to be published early Q2 2012. Also a reference that

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		the hedge accounting phase was not a joint project with FASB. On portfolio (macro) hedging, reference to the fact that the model being explored by the IASB was very different to the current hedge accounting model so the Board was likely to decide to issue a DP rather than an ED during 2012.
Apr 2012	DPOC	References in <i>DPOC: Due Process Update</i> (AP3G) as in papers for Trustees January and April 2012 and comment again that IASB had yet to complete its formal review of due process steps.
Jul 2012	Trustees	References in <i>Report of the IASB Chair</i> (AP2) and <i>The Technical Agenda</i> (AP2B). Comments as for April 2012 but now noting that review draft document was expected to be published in the middle of 2012. Report also noted that, due to complexity of accounting for macro hedges, in May 2012 the Board agreed to first publish a DP before moving to an ED. The Board was targeting publication of this document in 2012. Paper AP2 also noted that: "In the interim, the portfolio hedge accounting requirements in IAS 39 Financial Instruments: Recognition and Measurement would be retained, enabling entities using those requirements to do so until any new model is put in place".
Jul 2012	DPOC	References in <i>DPOC: Update on Technical Activities</i> (AP4D) as in papers for Trustees July 2012. On portfolio (macro) hedging a comment that stakeholders had agreed with the IASB's decision to first issue a DP, because it provided an opportunity to obtain more extensive feedback.
Oct 2012	Trustees	References in <i>Report of the IASB Chair</i> (AP2) to the review draft of the forthcoming hedge accounting requirements being posted to the website in September 2012. The paper noted that the IASB was not seeking comments on the review draft: "It is being made available to enable interested parties to familiarise themselves with the document and to provide the IASB with the opportunity to undertake an extended fatal flaw process. The Review Draft will remain on the website until early December 2012, after which the IASB intends to incorporate the Hedge Accounting requirements into IFRS 9 subject to confirming that all due process steps have been complied with". On portfolio hedges, the comments on the interim position were as reported to the Trustees in July 2012. It was noted that the IASB is aiming to publish the DP in 2013.
Oct 2012	DPOC	References in <i>DPOC: Update on Technical Activities</i> (AP3B) as in the paper for the Trustees October 2012.
Jan 2013	Trustees	References in <i>Technical projects – Update</i> (AP2B) which noted that the staff would summarise the key issues raised on the review draft in the January 2013 IASB meeting, together with a report that all due process steps had been complied with and asking the IASB permission to proceed to a final standard. At that time, it was noted that the IASB intended to finalise the general hedge accounting requirements in Q1 2013 (subsequently delayed by the IASB asking for more analysis regarding the scope of the new model). On portfolio hedges, it was noted that public discussions continued. On the interim position, the paper now stated that "the fair value interest rate portfolio hedge accounting requirements" in IAS 39 would be retained.
Jan 2013	DPOC	References in <i>DPOC: Update on Technical Activities</i> (AP3C(ii)) as in the paper for the Trustees January 2013, also noting that comments provided by constituents on the general hedge accounting review draft would not be posted publicly, as the IASB had not asked for letters to be formally submitted. The paper on due process steps for the January 2013 IASB meeting (IASB AP4D) was circulated to the DPOC. The <i>Report of the DPOC meeting</i> stated that the DPOC received a report summarising the due process to date on the project and the reactions that had been received to the draft of the proposed requirements posted on the

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		IASB's website. The DPOC noted that noted that some stakeholders continued to have concerns with the IASB's technical decisions, in particular its decision not to grandfather all aspects of current practice for accounting for macro hedges until the separate macro hedge accounting project was completed.